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Changes in U. S. Corporate Governance:

What changes have occurred and why should they be considered by Japanese firms?

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Abstract

After reviewing the legal changes beginning in 2002 in the U. S. and elsewhere, this study examines the size of boards, the number of and independence of directors, the separation of the Board Chairman (CBD) and CEO, and the role of auditors by comparing U. S. firms (based on the DJ 30 firms) to Japanese firms. The methodology uses data on the DJ 30 firms derived primarily from annual reports and firm web sites. Data from Japanese firms is based on a 2004 survey by the authors of Nikkei 225 firms as well as journals and news sources.

Findings show that although comparable changes have decreased the size of boards in U. S. and Japanese firms, the composition of Board members as insiders or outsiders differs dramatically. Outsiders dominate at U. S. firms while insiders dominate in Japanese firms. Although legal changes now require U. S. firms to look at the independence of board members, Japanese laws currently do not require such independence. Despite calls for the separation of the CEO and CBD roles from academics and institutional shareholders, corporations in both the U. S. and Japan generally select one person for both roles. Finally, the legal changes have given auditors of U. S. firms greater authority and have mandated more independence, while in Japan the dominant governance system already relies on external statutory auditors, although they are not always independent.

Although cultural differences between Japan and the U. S. will continue to be reflected in variations in governance systems, effective systems should include using a significant number of independent directors on a board of manageable size where directors have access to needed information. Separation of the CEO and CBD roles and independent auditors with clear authority are also critical components.

Key Words: corporate governance, U.S. corporate law, Japanese corporate law, board of directors, accounting, auditing, management

LEGAL REFORMS IN THE UNITED STATES

Impetus for Governance Reform in the United States

In the United States, the impetus for reform emerged after numerous governance scandals came to light. More than a dozen corporate financial reports were found to contain misstatements and omissions that probably were deliberate attempts to provide misleading or false information. A few corporate executives engaged in criminal behavior. In most cases, the

CEO and the Board of Directors at these firms claimed to be unaware of what was happening under their supervision.

As the scandals became more widespread, the losses for stockholders, employees and other stakeholders mounted. According to reports compiled by Bloomberg.com and Yahoo Finance. com, as of August 2002 the scandals at Enron, Global Crossing, Adelphia, Tyco, Xerox, World Com, Arthur Andersen, ImClone and a few other firms have led to billions of dollars in lost stock value and at least one hundred thousand lost jobs (*USA Today,* 2004). Subsequent scandals and financial irregularities added to these losses and led to a hue and cry, particularly from shareholders, for reform of corporate accountability. The U. S. Congress reacted swiftly and significantly to hold both firms and executives legally accountable for misdeeds.

Legal Response to Demand for Reform

On July 30, 2002 Congress enacted the Sarbanes-Oxley Act (SOX) to redefine and strengthen corporate governance.[1] A new Public Company Accounting Oversight Board was created to oversee the audits of public companies. The law specifies who is responsible for internal controls and financial reporting, details the authority and expertise of the audit committee and explains its role vis-à-vis external auditors (SOX-secs. 201-209, 301-308 and 407). It represents the most sweeping change in U. S. securities laws since the nineteen thirties.

The act affects U. S. public companies, foreign firms subject to the U. S. securities laws, public accounting firms and regulatory bodies like the New York Stock Exchange and NASDAQ[2]. Both private for-profit firms and non-profit organizations also are affected by the law as lenders, governmental agencies, and private donors look to see how those entities deal with the issues addressed by the legal reforms.

Since the law's passage, both the SEC and the major stock exchanges have imposed new requirements on public firms. The SEC adopted a dozen major rules that deal with insider trading reports, the independence of outside auditors, and accelerated disclosure requirements and reports on internal controls over financial reporting (SEC).[3] The New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) approved new listing standards that require all listed companies to have an internal audit function, to obtain shareholder approval of some executive compensation plans and to have a majority of board members be independent.

The Corporate Governance Reforms

Taken together, the Sarbanes-Oxley Act, the SEC rules, and the NYSE and NASD rules addressed the three main areas of corporate governance that need reform: corporate accountability and disclosure, the independence of the board of directors, and the role of auditors (SOX-NASD & NYSE). Recently, the role and compensation for the CEO and the CEO's role vis-à-vis the Board also has become a governance concern.

Corporate governance research and interest has proliferated since the scandals at the beginning of the millennium came to light. Although this article's focus in on governance in U. S. and Japanese firms, how governance works in different countries and cultures has been

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1 15 U.S.C. 7201-7266 (2002).

2 SOX section 2's definition of "issuer" includes any firm that issues registered securities and section 106 explicitly includes foreign accounting firms as being subject to rules of the Accounting Oversight Board.

3 For a comprehensive list of post Sarbanes-Oxley SEC rules related to corporate governance, see http:// www.protivi.com/knowledge/sec.reprts/ibdex.html.

the subject of significant research for years and it is in this area that this article adds to the literature. Both Aoki (1995, 2005) and Mallin (2004) have authored books that examine corporate governance structures in different countries. Most comparative analyses, such as Sandra Miller's UK, U. S. and German article (2002) or Fort and Schipani's U. S., German and Japan article (2000) compare corporate governance structures from Europe, North America and Asia. This research adds new data and insights into changes occurring in U. S. and Japanese firms, thus lending support for the argument that a convergence of governance structures may be occurring.

Corporate Accountability and Disclosure

In theory, the Board of Directors of a corporation is accountable to the shareholders who elect them and corporate officers are accountable to the Board of Directors who put them in charge of day-to-day operations. The Board's oversight role is to monitor the actions of its managers to ensure they are effective, legal and even ethical. In addition to being accountable to their shareholder-owners, corporations, particularly large public ones, are recognized as affecting many stakeholders — employees, suppliers, customers and communities. Modern stakeholder theory usually holds the Board of Directors accountable to these groups as well (Freeman, 2001). According to Professor Cindy Schipani of the University of Michigan Business School:

> "the accountability of corporate boards in corporate governance has evolved over the years, and, courts and legislatures often are caught in balancing acts. Historically, the challenge was to strike a balance between holding directors accountable to shareholders and not overly constraining their ability to perform their job. But these are not the only balances that need to be considered. Most states permit that in making certain corporate decisions, officers and directors can consider the welfare of other corporate constituencies in addition to shareholders. Once the facts of the Enron and other situations fully come to light, questions will arise not only about accounting practices and regulations, but also about the role of the board of directors and its oversight function. Only time will tell how these issues will be resolved, but it wouldn't be surprising to find the courts and legislatures strengthening the boards' oversight function in an effort to promote more corporate accountability." (2004).

Corporate laws in the United States give directors and officers the flexibility to balance shareholders' interest against other stakeholders (Mitchell, 1992; Wallman, 1999). However, what may have occurred at most firms involved in the scandals is that the officers were focused neither on shareholders nor stakeholders, but only for themselves. William Powers, Chair of a special committee on practices at Enron's Board, told a U. S. House committee "there was a systematic and pervasive attempt by Enron's executives to misrepresent the company's financial condition" (*NY Times,* Feb 05, 2002). Enron's Board was criticized for failing to ask pertinent questions or to seek explanations regarding transactions that moved debt off the firm's balance sheet (Abelson, 2002).

The corporate scandals also brought to the fore another problem, ensuring the accuracy of information. Various stakeholders need accurate information about a corporation's products, employment, environmental initiatives, expansion plans and financial performance. Financial reports at numerous corporations have had to be restated, in some cases for several years. Reporting irregularities continue to be a major problem and recently have focused on the backdating of stock options for executives at firms like Apple (*Wired News*).

Although it seems reasonable to assume that the CEO is the person who is accountable for all corporate information, the legal responsibility for certain information needs to be clear. Former Enron CEO Jeffrey Skilling said he was unaware of the company's questionable partnership practices that were used to conceal debt from Enron shareholders. "This was a very large corporation. It would be impossible to know everything going on" (Labaton and Oppel). Because of such statements, the Sarbanes-Oxley Act imposes duties on the CEO and CFO with penalties for violations.

The Annual Report must contain an 'internal control report,' stating the responsibility of management for establishing and maintaining adequate internal controls and procedures for financial reporting. Both the CEO and the CFO must certify the effectiveness of the company's internal controls as well the adequacy and accuracy of financial reports (SOX-sec. 404). Sanctions and penalties may be imposed on the CEO and CFO if they do not properly report financial information (SOX-sec. 1350).

Independence, Size and Knowledge of the Board of Directors

Corporate law theory holds that the board's primary role is to monitor management's actions on behalf of the shareholders. "As representatives of shareholders, directors serve to safeguard the assets of the corporation." (Monks and Minnow 2001, p.164) The strength, and indeed survival, of any corporation depends on a balance of two distinct powers: the power of those who own the corporation and the power of those who run it. A corporation depends on shareholders for capital, but reserves the day to day running of enterprise for managers.

Several corporate governance issues concern the work of the Board of Directors. Because board members are supposed to exercise their independent judgment in making corporate decisions, since the 1970s, there has been a constant push in the U.S. for greater outside representation on boards. SEC Commissioner Cynthia Glassman noted in a recent speech that "As we examined various scandals that had occurred, director independence increasingly was seen as a missing element necessary to position the Board to oversee management, foster integrity and prevent such misbehavior from occurring" (Glassman, 2004). However, even though U. S. directors usually are from outside the corporation, their friendship with and dependence upon the CEO means they may lack needed independence. Shareholders want directors, whether from inside or outside the firm, to exercise truly independent judgment.

Both the NYSE and NASDAQ have toughened their rules requiring director independence. Each requires a majority of a publicly traded corporation's board to be independent, but they differ slightly as to how to best determine such independence. The NYSE specifies that a director who has a "material relationship" with the listed company cannot be considered independent while NASD focuses on whether the director has a relationship which interferes with the exercise of independent judgment in carrying out the responsibilities of a director. (NYSE and NASD) Companies listed on the exchanges must have compensation and nominating committees composed solely of independent directors. Other measures aimed at independence include restricting directors' fees and prohibiting personal loans (SOX-sec 402a).

In addition to the selection process and independence of directors, the size of board may influence a board's effectiveness. A board that is too big may be unworkable. In 1993 Rawleigh Warner, a director at American Express, noted, "The size of the board does make a difference." The American Express board had 19 members and four advisors to the board. That large a board, I believe, makes for an unwieldy number and prevents an opportunity for each member to speak freely (Monk and Minnow, 2001, p.175).

A final issue related to corporate directors concerns their knowledge, particularly of financial and accounting issues. The Enron board, especially its Audit Committee members, has been criticized for the lack of attention to the off-book financial entities with which Enron did business. Professor Hideki Kanda of Tokyo University points out that for the members of any Board's Audit Committee, both independence and "financial literacy" should be required (2001). Similarly, the directors should have approval over information flow to the board, meeting agendas and schedules to ensure they have sufficient information and time for discussion of agenda items (Gray, 2004).

The Role of Auditors and the Audit Committee

Because the Enron scandal led to the downfall of its auditor Arthur Andersen, questions have been raised about the duties and responsibilities of both external and internal auditors. External auditors may have conflicting interests, such as also being consultants to firms while receiving minimal audit fees as compared to their consulting income. Internal auditors must have access to accurate information and ensure that adequate internal controls exist to prevent financial misdeeds or cover-ups.

The Board's Audit Committee and Internal Auditors

Enron's audit committee and its internal auditors were criticized for not carrying out their oversight function and for failing to discover problematic accounting practices, particularly with the firm's off-balance sheet partnerships. Mervyn King, Chairman of South Africa's King Committee on Corporate Governance has said that "Enron executives were just 'box-ticking' so they could say, 'Yes, we are in compliance with the rules'. The Enron Board was not applying what I call quality of governance. It did not accept the idea that the market is the ultimate compliance officer" (Bisoux, 2004).

On the other hand, the chairman of the audit committee, Robert Jaedicke, a former Stanford Business School Dean, stated that he and other members of Enron's audit committee were misled. He said, "(T)he lifeblood of the work of any Audit Committee is the development and implementation of adequate controls, many of which cross check each other. And the oversight function of the Committee depends on the full and complete reporting of information to it. Without full and accurate information, an Audit Committee cannot be effective." (Financial Collapse of Enron, 2002). He blamed Enron's management and outside consultants for providing wrong information.

Both Sarbanes-Oxley and the NYSE requirements include provisions to increase the authority and responsibilities of the Board's Audit Committee and to ensure that it has the necessary independence and expertise. The Audit Committee must have the sole authority to hire and fire a company's independent auditor, to pre-approve any significant non-audit related expense and to engage independent counsel and other advisors (SOX-sec. 301 (5)). Now, NYSE and NASD requirements specify that all audit committee members must be financially literate, with at least one member having extensive accounting or financial management expertise (NYSE and NASD).

External Auditors

Since external auditors are hired to check on the corporation's financial records, it is unlikely that corporate executives who may not want the records questioned will want aggressive independent auditors. Thus, responsibility for hiring external auditors should rest with independent Board members, not with corporate executives. Sarbanes-Oxley Act imposes a number of requirements related to partner rotation, auditor's reporting, cooling off period, and prohibited activities. The requirements include having the lead audit partner and reviewing audit partner rotate every five years. Prohibitions on conflicting work by external auditors include appraisal or valuation services, actuarial services, internal audit outsourcing services, management services, investment banking services and legal services unrelated to the audit (SOX 201 (a)).

REACTION TO LAW IN U. S. CORPORATIONS

The Sarbanes-Oxley legislation and the SEC, NYSE and NASDAQ rules require U. S. corporations to address several governance issues such as the size of boards, the number of independent and inside directors, and the separation of the CBD and the CEO. We have examined what the firms in the 30 Dow Jones Industrials, who can serve as a proxy for what is occurring in corporate America, are doing about these governance concerns. The responses to the law from the companies, summarized below, have been quite extensive. For example, General Motors developed guidelines in thirty-five areas ranging from the selection of new board members to the size of the Board and the Board's relationship with senior management (General Motors, 2003).

Summary of Governance Structures at the 30 Dow Jones firms

After examining individual data, we have compiled a composite of governance structure in the Dow Jones 30, and by extension in corporate America. Table 1, which summarizes the data, looks at the size of the Board, the number and background of inside directors on the Board and the relationship between a firm's CEO and its CBD.

Size and Independence of Board

Table 1, which depicts the size and independence of members of the Boards at the 30 Dow Jones' firms, shows Board size varies from as few as 9 members at HP and Microsoft to as many as 17 at AIG. and ATT. With the average being 12.6, six firms have 11 members and five have 12. According to Spencer Stuart's survey of large US companies, the average board size was 15 in 1988 and 10.5 in 2005 (Stuart 2005). The size of boards at most public Japanese firms is comparable to the size in the U. S. firms. According to a report by NLI Research Institute in Tokyo, the average size of companies in the first section of the Tokyo Stock Exchange was 17.6 in 1996 while in 2004 it was 10.4. The average at the NIKKEI 225 firms in 2004 was a little larger, 15.5 (McCarty and Toda, 2006). Both figures are comparable to the 2004's 12. 6 average that we found for the DJ 30 firms.

Table 1 Composite View of DJ30 Boards and CEO Governance

Board Size	The average board has 12.6 members.
Number of Inside	The average number of inside directors is 1.7.
Directors	Only 5 firms have more than 2 inside directors.
Who are Inside Directors?	The CEO and Chairman are the only inside directors at 15 firms.
CEO & Chairman*	The CEO and Chairman are separated at 6 firms. The former Chair, President or executive sits on 2 boards.

Data is based on firms' home pages as of January 15,2007.

Insiders or Outsiders?

As noted in Table 2, at the DJ 30 firms each Board of Directors is composed of at least

Table 2　Board Size and Number of Inside Directors at DJ 30 Companies

	Board size	Officers and Chairman	
3M Company	10	1	
Alcoa Inc.	10	1	
Altria Group	1		
American Express	11	1	Chairman & CEO
AT&T Corp.	17	2	Chairman & CEO, COO
Boeing Co.	10	1	Chairman & CEO
Caterpillar Inc.	13	1	
Citigroup	16	2	Chairman & CEO, Chairman of the executive committee
Coca-Cola Co	11	1	
DuPont	11	1	
AIG	17	2	CEO, Senior Vice Chairman
Exxon Mobil	12	2	Chairman & CEO, Senior Vice President
General Electric Co.	15	4	Chairman & CEO, Vice Chairman（3）
General Motors	11	1	
Home Depot Inc	12	1	
Hewlett-Packard	9	2	Chairman & CEO, CFO
Honeywell Intl Inc.	14	1	
Intel Corp.	11	2	Chairman, CEO
IBM	13	1	
Pfizer	15	3	Chairman & CEO former Chairman & CEO（2）
JP Morgan Chase	14	2	Chairman & CEO, Senior Advisor
Johnson & Johnson	13	2	Chairman & CEO, Executive Vice Chairman
McDonald	13	2	Vice Chairman & CEO, Non-Executive Chairman
Merck & Co	12	1	
Microsoft Corp.	9	3	Chairman, CEO, Former President &COO
Procter & Gamble	16	3	Chairman & CEO, Vice Chairman（2）
Verizon Communications Inc.	14	1	
United Technologies	12	1	
Wal-Mart Stores	14	3	Chairman, , president & CEO
			former CEO
Walt-Disney Co.	12	2	Chairman, CEO
Total	378	51	

Data based on the firms' home pages as of January 15, 2007 nine members (an average of 12.6), usually with only one or two being *inside* directors. At 15 of the DJ 30 firms, the CEO (or CEO who is also the Chair) is the only insider. Where two insiders are on the Board, they are most commonly the CEO and a separate Chairman. Only five boards have more than two insiders and in four of those Boards, there are only three insiders.

A Board's composition of insiders and outsiders in U. S. firms is directly opposite to what we find in Japanese firms. According to the Japanese Investor Relations and Investor Support, Inc., the Tokyo Stock Exchange firms average only 1.0 *outside* director with the NIKKEI 225 average being 1.79 (McCarty and Toda 2006). The difference in who is on the board — whether from inside the firm as in Japan or from outside as in the U. S. — has significance for both of the Boards' major functions — monitoring and developing long-term strategies. The governance problem with the U. S. firm structure is that Board members from outside the firm, usually executives at other firms, may be unable to devote sufficient time or have the requisite knowledge to aid in developing long-term strategies. Similarly, as outsiders they may be unwilling to impose restraint in setting either CEO or Board members compensation and benefit packages or to challenge proposed operational plans. In most Japanese firms almost all directors are appointed or, to be more exact, promoted internally by CEO. The problem with this structure is that board members are unlikely to effectively monitor managers or to seek to restrain executive compensation.

Separation of CEO and Chairman (CBD) positions

If the Chairman of the Board of Directors (CBD) is also the CEO of the company, how can the Board, under the leadership of its CBD, monitor the CEO and other executive managers of the company? If governance at a corporation is to include monitoring of executives by the Board, the need to separate the positions of CBD and CEO of the company seems obvious. The Guidelines for Intel Corporation's Board of Directors specifically require the separation of the position of CBD and CEO as an aid in the board's oversight of management (Intel, 2007).

Shareholders, who view the Board as representing their interests, are increasingly calling for a separation of these positions (Taub 2003). In early 2003, the Conference Board recommended that the CEO and CBD positions be split with the CBD position filled by an independent director (Conference Board, 2003). While such a split is not the norm in either the United States or Japan, in the United Kingdom, 90% of listed companies do split those positions (Conference Board, 2003). Harold Green, former CEO and CBD of ITT Corp., poses the problem encountered when the CEO is on the Board, whether as CBD or as an inside member. "If the board of directors is really there to represent the interest of the stockholders, why is the chief executive on the board? Doesn't he have a conflict of interest? He's the professional manager. He cannot represent the shareholders and impartially sit in judgment of himself" (Zehnder, 1989).

In Japan, it is common for the CBD to be the former CEO or President. The rationale for keeping one person in the two positions is based on ensuring that only one person is in charge of the firm. A respondent to a 1992 Korn/Ferry survey concluded, "They should be the same person. If they are not, the Chairman would be a figure-head or would usurp the role of the CEO" (Korn Ferry, 1992). This view appears to be the dominant one in most top U. S. firms as CEOs were also the CBD in 93% of the largest companies (Korn Ferry, 1998).

Our DJ 30 survey reveals only six DJ 30 firms, including Intel and Disney, separate the two positions. The policy at Intel is the clearest of any firm. "The Board's general policy, based on experience, is that the positions of Chairman of the Board and Chief Executive

Officer should be held by separate persons as an aid in the Board's oversight of Management" (Intel, 2007). Despite the debate, shareholders appear to be right in seeking to change the status quo. In terms of corporate performance one study found that "companies with separate CEOs and Chairmen consistently outperform those companies that combine the roles" (Monks and Minnow, 2001, p.175).

Unique Governance Characteristics in selected 30 DJ companies

Although most companies have adopted fundamentally similar governance principles, a few added details in critical areas while others address unique concerns. What do the governance principles say about the independence of board members and how is independence defined? How do corporations select say board members?

Two other governance issues examined at specific firms include the role of the board's audit committee and the importance of stakeholders. The role and authority of a firm's audit committee has increased due to the provisions of the Sarbanes-Oxley Act. Do corporate governance principles reflect the heightened role for this committee? Finally, we examine what some of the firms say regarding their stakeholders. Is there a commitment to look out for the interests of stakeholders other than the shareholders? Is there any indication as to which stakeholders interests' are of greater importance?

All firms include policies that show the critical importance of having independent directors. In 1992, Board members forced Board Chairman James Robinson to resign (Monks and Minnow 2001, p.347). As a result, the governance policies at American Express define what constitutes an independent director. Several specific situations that can prohibit a person from being independent and examples of prohibited "material" relationships are noted. Boeing's governance principles call for a "substantial majority of independent, non-management directors." and recently nine of eleven of Boeing's directors were "independent" under the NYSE (Boeing, 2002).

Several firms include governance statements regarding their stakeholders. Disney states that: "(T)he Corporation has a responsibility to the communities in which it operates, as well as to its shareholders....The Board shall reflect the diversity of the (Corp.'s) shareholders, employees, customers, guests and communities" (Disney, 2004).

While most corporations note that customers are one of their important stakeholders, Hewlett Packard's (HP's) corporate objectives highlight the customer focus more clearly than do other firms. HP emphasizes loyalty to the customer as the top priority, followed by making a profit and creating value for the shareholders.

Microsoft notes that selecting Board members requires a consideration of many factors. However, it seeks to recommend for its Board a group that can best "represent shareholder interest". Thus, while its Board, like Disney's, should have a diversity of experiences, it seeks members who will represent the shareholders, not a diverse group of stakeholders (Microsoft Corporation, 2004).

Kodak brought corporate governance issues into its management structure by appointing in July 2003 the company's first Chief Governance Officer (Eastman Kodak Co., 2004). It will be interesting to see if many other companies follow Kodak's example of assigning a high-level person to specifically look at governance issues. Could the CGO follow the CIO as new executive positions in major firms?

RECOMMENDATIONS

This article has examined changes in corporate governance structures in U. S. firms after the 2002 scandals. Our findings suggest that effective corporate governance structures must address concerns affecting the Directors, the CEO and the stakeholders.

Board of Directors

An effective Board of Directors must include independent directors who must have access to needed information to effectively monitor financial statements and to review strategic decisions of managers. Boards need to ensure that management is held accountable for its decisions and that active information disclosure processes are in place. Boards also need to address governance issues related to the CEO, such as whether to separate the position from the Chairman's position and how to set an adequate, but not exorbitant, level of compensation. Finally, Boards must be attentive not only to the shareholders who elect them, but also to other stakeholders whose interests also merit consideration.

Composition of the Board Of Directors

An effective Board of Directors should be of reasonable size with a significant number of independent directors and with access to needed information from both internal and external sources. The stark difference in the inside vs. outside composition of boards in Japan and in the U. S. relates to the importance attached to the board's twin functions, establishing management policies and strategy and monitoring the management. Boards always have, and always will, simultaneously serve both the functions. As SEC Commissioner Cynthia Glassman has noted, "we should recognize that there is an undeniable tension between the dual roles of directors as partners with management in running the company on the one hand, and as judges of management's performance on the other" (Glassman, 2004).

In order to perform the monitoring/oversight function, we believe that effective governance requires that independent directors usually should make up a majority of the total board. Even when a majority of board members are outsiders, they cannot always be considered independent. While inside directors generally perform well the strategic oversight and mediating functions, at critical times, other roles and responsibilities of outside independent directors are crucial (Black, 2001). Outside independent directors play crucial roles in replacing the CEOs in times of crisis as well as in challenging a CEO's financial misstatements or self-interest actions. Furthermore, outside directors may have a duty of special care when a firm is a takeover target.

A recent Delaware ruling held an outside director personally liable for approving a transaction that was not in the best interest of the firm. The ruling raises the specter of increasing personal liability for neglect of duty by outside board members (Kirchgaessner, 2004). Our opinion is that well-chosen, independent; outside directors are needed to monitor the firm's managers and their strategic decisions. Insiders cannot provide the independence and needed external perspective. On the other hand, insiders provide access to information from employees, suppliers and customers that usually can not be obtained by outsiders. Thus, insiders can and do make valuable contributions, particularly to the management function of a board.

Number of Directors

To be effective and workable, the number of directors needs to be limited. The consensus among firms with larger boards appears to be that they do not work well. Almost all firms have recently reduced the size of their boards. While no magic number of board members is desirable, where boards have more than a dozen directors, each may be less likely to raise issues and question management than when fewer members emphasize the critical role each person has for the work of the entire board.

Access to Information to and by Directors

It is crucial that independent directors have access both to management and to outside resources and receive full, timely, complete and accurate information. Similarly, employees and managers should have access to Board members. Reporting of concerns to independent directors or an Audit Committee, as described in GE's guideline, is important to establish an enhanced risk management system (General Electric).

The CEO

The two main issues affecting the CEO concern the relationship between the CEO and the CBD and the setting of compensation for the CEO. While both of these issues are still controversial in many U. S. firms, we believe effective governance is more likely when the following recommendations are followed.

Separation of CEO and Chairman

Although the practice in many firms is at variance with our recommendation on this topic, we conclude that a separation of the CEO and CBD roles helps to make clear the distinction between the monitoring function, which the CBD is responsible for, and the execution function, which the CEO performs. When the CEO is also the CBD, the Board is not likely to challenge any of the CEO's recommendations. The worry that two leaders in one firm may send unclear signals as to corporate strategy seems to us to be misplaced. In nearly all cases, the two leaders will be "on the same page" as to corporate strategy and when they are not it often may be that the CBD is raising issues on behalf of the shareholders or stakeholders that need to be heard.

CEO Compensation

Clearly, a capable CEO, working in a strong and agile management system, will enhance a firm's competitiveness. However, there seems to be widespread agreement that some CEOs, particularly in the U. S., are paid too much. In 2001, the average CEO compensation in the U. S. was 411 times the compensation for the average line workers in 2001. By comparison it was 43 times in 1980. Kazuo Inamori, founder and Chairman emeritus of Kyocera argues, "Of course, a leader should be given a certain amount of power and compensation. However, directors, officers, general managers, department heads and tens of thousands of other employees are also working together and producing profit for corporation through their joint efforts. Corporate profit is the fruit of such joint efforts and should be shared with all people (*USA Today*, 2003).

The Stakeholders

Today, environmental and social responsibility issues are becoming critical for corporations and their customers, suppliers, employees and investors. While pressures to satisfy shareholders often conflict with maintaining or enhancing the welfare of employees, an effective corporate governance structure can serve both interests.

Corporate Governance in Japanese firms

As Japanese firms move towards different governing systems, their need for board members with independent views will take different forms. For firms that do not move to a "Company with committees system" but continue to use the statutory auditor to "monitor" managers' decisions, the independence of most of the statutory auditors becomes critical. In addition, adding even a few outside members to the Board is likely to change the deliberations for the better. Firms that do switch to a "Company with Committees System (Comm.)" give up the outside statutory auditor who brings needed external perspective. For these firms, it is important that they develop a structure to ensure that effective monitoring will still be performed.

Responses to our survey of the NIKKEI 225 firms showed that over 80% of the 49 respondents were **not** contemplating a change to the Comm. System of governance. The reluctance to change is natural given that insiders would be replacing themselves with outsiders. Further, the respondents raised concern with the lack of knowledge by outsiders of firm problems and strategies and the perceived lack of qualified candidates. Still, outsiders are being added to most boards and several executives we interviewed indicated searches for outsiders likely were more widespread that was being reported.

Even though most firms are not opting for the new system, important changes in the size and makeup of board members in Japanese firms is occurring (McCarty and Toda, 2006). According to the NLI Research Institute in Tokyo, the board size of listed companies in the First section of the Tokyo Stock Exchange has decreased from 17.65 in 1996 to 10.37 in 2004. Outside directors now account for approximately one-third of all directors (as of 2004) in nearly 20% of firms as compared to only 11% of firms in 1996. Finally NLI found a statistical significance between a firm's ROA and the increase in outside directors and decrease in board size (Nippon Life Institute).

Even where the governance system remains the same, improvements are being made. Both Matsushita and Toyota have modified their governance system to establish a system that blends features of Japanese and U. S. systems. Their boards focus mainly on monitoring and strategy while operational issues are dealt with by corporate officers. They do not completely separate supervisory and execution functions as they include both supervisory and operational representation on their boards.

Finally, all Japanese firms would benefit from additional changes in Japanese governance laws so as to require firms using the "Company with Committee system" of to include a majority of independent directors on the board. We have noted that the law does provide for independence where the statutory auditor system is used.

An earlier article on the role of boards concluded that "the proper balance between the paradigms of the Board as manager versus monitor will differ depending on a number of company-specific characteristics" (Fisch, 1997). We would add that cultural differences also affect that balance. The unique strengths of Japanese companies took root in the fertile ground of history and culture. By utilizing those strengths and considering the development of improvement in corporate government system in the U. S., Japanese companies should establish their own competitive corporate governance structures. Globalization will continue to force Japanese and other multinational companies to follow the emerging "global standard" in corporate governance as well as in other endeavors. Although the method of implementation will differ, directors and officers of firms located in the U. S., Japan or elsewhere have the responsibility to adopt and implement an effective and competitive corporate governance system that best suits their company's ability to grow and to respond to the needs of their stakeholders.

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